THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

6 July 2009

Our ref: ICAEW Rep 72/09

Your ref:

European Commission,
DG Internal Market,
Unit G1 ("supervision consultation"),
B-1049 Brussels

By email: markt-g1supervision@ec.europa.eu

Dear Sir

CONSULTATION ON COMMISSION COMMUNICATION OF 27 MAY 2009 ON EUROPEAN FINANCIAL SUPERVISION

The Institute of Chartered Accountants in England and Wales (the ICAEW) is pleased to respond to your request for comments on the *Consultation on Commission Communication of 27 May 2009 on European Financial Supervision*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

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ICAEW Representation

ICAEW REP 72/09

CONSULTATION ON COMMISSION COMMUNICATION OF 27 MAY 2009 ON EUROPEAN FINANCIAL SUPERVISION

Memorandum of comment submitted in July 2009 by The Institute of Chartered Accountants in England and Wales, in response to the *Consultation on Commission Communication of 27 May 2009 on European Financial Supervision*.

Contents	Paragraph		

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to comment on the *Consultation on Commission Communication of 27 May 2009 on European Financial Supervision*.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 165 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

4. The ICAEW's Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest and free from vested interests. It draws together professionals from across the financial services industry and from the 25,000 ICAEW members specialising in the sector. This includes those working for regulated firms, in professional services firms, intermediaries, and regulators.

MAJOR POINTS

5. The ICAEW supports a greater degree of regulatory consistency and coordination across the EU, provided it results in workable arrangements that address public interest needs without posing disproportionate compliance burdens on businesses and regulators.

6. The ICAEW encourages EU work streams to be synchronised with the ongoing international dialogue taking place within the G20 framework and the newly created Financial Stability Board (FSB). We strongly believe that the proposed European authorities need to co-ordinate their effort with the FSB.

7. We do not believe that there is a need for a single European regulator, dealing both with policy and day-to-day supervision. And we see clear dangers in separating policy from operational supervision, since close links between the two are essential. We also see dangers in seeking a profusion of international bodies to provide macro-prudential supervision and oversight of national micro-prudential bodies, which could dilute the impact of each, though we see scope for close co-ordination of work on macro-prudential issues across the EU.

8. Principles based regulation should not be confused with light touch regulation. The ICAEW supports the policy of more principles based regulation as it provides the basis for a more robust system, better able to cope with changing circumstances. Compliance with principles can be more demanding than applying

rules, as a good set of principles addresses substance rather than legal form, which rules tend to focus upon. We note that the more rules based US system of regulation did not cope demonstrably better with the current crisis. Principles based systems need to be supported by effective supervision, because the applications of principles involves an element of judgement.

9. Better methods of monitoring and co-ordinating the regulation of banks are needed due to the systemic risk inherent in the system. Such methods must be developed at an international level, due to the global nature of financial markets. Measures adopted in a single jurisdiction will not be sufficient to address the weaknesses in the regulatory framework as the risks are global. This does not, however, necessarily require a new international regulator to be created.

10. In any regulatory or control system, there will always be tensions over where dividing lines should be set when more than one organisation is involved, as is always likely to be the case, both within and between countries. Clear definitions of the respective responsibilities between the authorities are more important than the choice of which organisation takes on which role.

European System of Financial Supervisors (ESFS)

11. We believe there is a need for greater consistency and coordination across the EU and better methods of monitoring and co-ordinating the regulation of banks are needed due to the systemic risk inherent in the interactions within the system. In that respect, we welcome the proposals from the EU Commission to establish an ESFS, but caution that the details of how this might work remain of key importance. We are supportive of the idea that the Authorities could improve the quality of supervision of financial services groups by participating in global colleges of supervisors, provided that existing lead supervisory arrangements are respected. This is particularly important for groups with significant operations outside of the EU.

12. The proposals should include more details to enable stakeholders to understand how the ESFS will work in practice. The proposals are at present very broad and do not explain how the objectives would be achieved. For example, the paper is not clear which 'powers' would be granted to the Authorities, the paper only refers to 'certain powers'. It would be very useful if the Commission could clarify what are these powers.

13. We strongly believe that to improve communication and coordination among the Authorities and national regulators, clear definitions of respective responsibilities are crucial. At present, the proposals are too general. It is also very important that the national regulators and the Authorities develop staff capabilities to ensure that the risks to the financial system are properly identified and corrective actions are taken in a timely manner.

14. The proposals also mention that the Authorities would have 'direct decision-making powers with regard to certain specific situations'. There is need for much greater precision on the circumstances in which such powers would be exercised in relation to specific firms or groups. We believe that as drafted some firms might be under the misconception that they would have to be accountable to both the national regulator and the Authorities. There are also well-known issues about the potential interaction between this and the effect on national fiscal responsibilities.

15. We strongly believe that for the ESFS to be effective it should be truly independent and its actions must be as far as possible transparent to stakeholders.

16. In developing technical standards and guidelines, the authorities must ensure that they do not stifle innovation. The paper states that there will be indicators such as financial stability, consumer and business confidence, international competiveness to measure and monitor the performance of the ESFS. It is not clear who will be responsible to measure and monitor the performance of the ESFS. It is also not clear how the indicators will be measured.

17. We are doubtful if a totally centralised policy-setting function is appropriate – countries differ in many ways and a single rule may therefore have different effects in different jurisdictions. Over-emphasis on 'level playing field' issues may also slow down the policymaking process. That said, unnecessary differences between rules are costly to firms – so it is important to strike a proper balance in this area. In addition a common rulebook - sufficiently detailed to ensure broadly consistent interpretation and implementation by all jurisdictions – would reduce the justification and capacity for goldplating, and the 'level playing field' issues.

18. We also believe that policy development must continue to be informed by the experience of national supervisors who are applying the rules 'on the ground' and similarly that the rules are more likely to be applied properly if there are national policy teams who can interact directly with their line supervisory colleagues.

European Systemic Risk Council (ESRC)

19. We support the establishment of the ESRC and agree with the de Larosière report that membership of such an organisation 'should be at the highest level': this would give the ESRC more credibility. Having said that, we strongly believe that as for the ESFS, the ESRC must be truly independent. The technical profile of members is not a sufficient condition to avoid major risk of political interference.

20. We welcome the fact that the ESRC would include central banks, national supervisors and the Authorities. However, there is an issue as to whether the proposed composition gives too much weight to central banks. As always there is also a risk that such a large group may be unmanageable, depending in part on how far it is given direct powers. We strongly believe that due regards should be given to the non Eurozone jurisdictions within the new framework.

21. The ESRC will only be effective if it can identify systemic risk and devise corrective measures in a timely manner. At present, the proposals are unclear on how the ESRC will achieve this, and on how it will interact with its global and non-EU equivalents. System risk can be a global issue. We strongly believe that the ESRC should coordinate their effort with the newly created FSB. This would enable the ESRC to identify risks at an early stage and devise more effective corrective actions. We remain unconvinced whether the new framework is capable of managing potential systemic risk posed by shadow banks.

OTHER COMMENTS

New rules

22. Liquidity risk has had insufficient attention from regulators in recent years. Regulatory regimes need to be updated to address the current and potential future liquidity risks in the financial system. As international banks are often managing liquidity on a group-wide, international basis, and as failures in this area can have global ramifications, the regulatory tools need to be international in nature.

23. We also believe that it is important to base the new regulatory system on a framework of principles, rather than the creation of ever more detailed rules to cover every possible scenario. Given that we are operating a global financial system, the Basel Committee on Banking Supervision should lead on examining improvements to the capital framework.

24. The relationship between bank auditors and regulators has been generally weakened in recent years. The Basel II framework does not specifically require the involvement of external auditors for supervisory purposes. However, the audit profession can contribute to greater confidence in banks by providing objective, expert opinions on the information reported by banks, so that those relying on that information can be confident that it has been properly prepared.

Financial Reporting

25. Confidence in financial reporting is vital if financial stability is to be maintained. In our view, while fair value is not appropriate in all cases, existing requirements within International Financial Reporting Standards (IFRS) for certain financial instruments to be measured according to fair value accounting are there for good reason and reflect the relative weakness of historical cost accounting, the main alternative, for these particular items.

26. The current financial crisis is principally an economic issue not an accounting one and there is insufficient evidence to conclude that fair value accounting has either caused or exacerbated the recent issues in the banking sector. Therefore, the ICAEW believes that to abandon the current use of fair value accounting as applied to financial instruments, would be to ‘shoot the messenger’ at a time when investors need more transparency, not less.

27. The Japanese crisis in the 1990s, characterised by financial institutions’ failure to report the extent of their non-performing loans and subsequent slow economic recovery, arguably highlights how not facing up to the scale of such problems as soon as possible can make their resolution more prolonged and painful. However, inconvenient the economic reality may be in the short term, transparent reporting is a key ingredient in long term economic recovery and must be protected and maintained at all times – those characterised by turmoil as well as by financial stability.

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